



April 15, 2013

U.S. House Committee on Ways and Means
1101 Longworth HOB
Washington, D.C. 20515

RE: Comments for the Small Business/Pass Through Tax Reform Working Group

Dear Working Group Chairman Buchanan and Chairwoman Schwartz:

The American Nursery & Landscape Association (ANLA) appreciates this opportunity to comment on the draft language before your tax reform working group, specifically regarding small business issues.

Founded in 1876, ANLA is the national trade association of the nursery and landscape, or “green” industry. ANLA membership comprises over 10,000 active members and affiliates that grow nursery and greenhouse plants, sell lawn and garden products, design, install, and care for landscapes, and sell supplies to the industry. Typical members include growers, garden center retailers, horticultural distributors, landscape professionals, and suppliers to the industry. A number of firms are engaged in more than one of these operations.

We are contacting you to share our initial thoughts and concerns regarding the suggested changes in small businesses’ access to cash accounting practices, particularly Section 212, which would amend Section 448. The nursery industry has a long history regarding specific tax accounting procedures for the industry that date back to 1922. The general principles are that nursery taxpayers, regardless of size, may use cash basis accounting, cannot be required to use accrual basis accounting, cannot be required to use inventory accounting, regardless of whether the taxpayer uses cash or accrual basis accounting, and finally such taxpayers cannot be required or can elect not to capitalize expenses.

Over the years, there have been some modifications to those general principles, but the general principles remain, as they were 90 years ago. The statutory, regulatory, and administrative authorities for those principles do not follow a straight line. In some cases, it is exception from a requirement, thus from a compliance standpoint, it is often “proving the negative.” Please view the attached “Appendix I” for a brief summary of the legal history of the issue.

From a practical standpoint, the nursery industry is a unique subset of agriculture and the principles behind the establishment and maintenance of the special considerations for nursery operations remain relevant today. Growing ornamental trees, shrubs and other plants presents challenges that are specific to nursery farmers. The cultivation and development stage of a nursery plant can range from months to a decade depending both on the plant variety, the needs of the consumer, and marketplace demand. Most nurseries are growing many varieties of plants that require individual attention. In terms of the number and size of plant species and varieties being grown, nurseries may range from specialists who grow only one species to those who grow over 2000 different species and varieties. Despite technological advances, maintaining inventories that can accurately quantify and value the tremendous variety of crops and crop-times would be a monumental task.

Adding to the complexity is the fact that there is often no continuity in how long a nursery may grow any of its crops or in what life stage the plants may be purchased, developed or sold (e.g., seed, seedling, cutting, sapling, 1 to 2 year, 2 to 3 year). Many nurseries grow their various plant types during different life stages and then sell them to be further developed by other growers – each having a role in the husbandry of the plant at different phases. Furthermore, operations are often intermixed in the age of the plants they work with which then in-turn creates a situation where the pre-productive phases of some of their crop would be below the two year threshold suggested in the draft legislation while other material would be above.

Unlike single season crops where the inventoried value is easily set, horticultural crops are always in development until they are sold. A plant may be ready for sale at any stage during its horticultural life or it may be kept in the ground or shifted from one container size to a larger one and kept on site for future seasons. This need for flexibility regularly changes the value of the plant but is necessary for dealing with natural phenomena like weather, pest and diseases. In addition, market issues can significantly alter the appropriate time of a sale and decisions to maintain material beyond a grower's initial intent. That kind of flexibility and freedom from accrual accounting with inventory allows a grower to:

- 1) Avoid waste by keeping material for an additional season or longer without destroying leftover stock and claiming the loss.
- 2) Avoid distress pricing and hold material until the market improves.
- 3) Buy large quantities of plants when pricing is favorable and maintain those plants for an extended period of time without presupposing the time of sale and hence the value.

Maintaining reliable cost figures for each tree, shrub, or plan in a nursery growing area would be nearly impossible. With most manufactured goods (e.g., car, television, hammer) the manufacturing cycle is relatively short and a homogenous, durable good is produced at the end. As a result, it is relatively simple to identify labor, material and overhead costs. Contrast that with a nursery grower and the plant products. How would

the value of the crop be established when the costs associated with the individual plant vary considerable over the undefined development period? Would the farmer be required to establish a means of allocating costs to their thousands and thousands of plants that frequently vary greatly in species and variety, size, age, and quality? Reallocating costs for the plants that die each year or are damaged would be another heavy lift in the inventory process.

We respect and appreciate the interest of the committee and your working group, in particular to create a more streamlined and easier to follow tax code for our nation's small businesses. Allowing smaller businesses of all types to avail themselves of cash accounting will provide greater flexibility for many. However, the nursery industry presents unique challenges that require many nursery farmers to maintain their access to cash accounting practices or risk going out of business.

The recent economic downturn has taken and continues to take a considerable toll on the nursery industry. One of the most respected economist studying the horticulture industry, Dr. Charlie Hall at Texas A&M, has estimated that there will be a, "30% attrition of nursery operations before an economic recovery takes hold." Many of these same operations are multigenerational family owned and operated companies. Although the taxes collected in the long-term would be the same, the shift in accounting practices would be a significant burden. There is significant concern that a required change in accounting practices could be a final blow to an industry that is already down and force most production offshores, as has happened with the cut flower industry. Furthermore, the requirement that farmers with revenues over the arbitrary \$10 million level must use accrual accounting practices with an inventory requirement would in itself be a market influencer and impact company competitiveness.

For example, if two businesses directly across the street from one another were friendly competitors – one with revenue of \$8 million and the other with \$11 million – this draft legislation would significantly tip the scales in improving the competitiveness of the smaller operation with its access to cash accounting and more immediate cash flow. The cash accounting company could expand more easily by claiming costs during the year of expansion while the other company could not. The proposed changes could act as a significant market influencer creating an imbalance in a competitive environment.

For the reasons described in these comments we strongly urge you to reconsider your decision to eliminate for nursery farmers of all sizes special consideration and access to cash accounting practices. ANLA recently formed an industry-based working group to discuss the proposed legislation and share perspectives on what the requirement to move to accrual accounting with inventory would mean to the industry. The overwhelming response has been that it would devastate the industry. As we continue to work with our group and identify the specific challenges that accrual accounting with inventory mean for nursery farmers, we will gather those and share them with your committee as appropriate. Again, we recognize your committee's interest in simplifying

the tax code and hope you see that this unique sector of American agriculture requires special consideration in order for it to remain a vibrant U.S. industry.

We appreciate the opportunity to provide comments and suggestions. Please do not hesitate to contact us if we can be of further assistance.

A handwritten signature in black ink, appearing to read "Craig J. Regelbrugge", followed by a long horizontal line.

Craig J. Regelbrugge
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Appendix I

The analysis begins with Internal Revenue Code (IRC) Section 448. It states in part:

26 USC § 448 - Limitation on use of cash method of accounting

(a) General rule

Except as otherwise provided in this section, in the case of a—

(1) C corporation,

(2) partnership which has a C corporation as a partner, or

(3) tax shelter,

taxable income shall not be computed under the cash receipts and disbursements method of accounting.

(b) Exceptions

(1) Farming business Paragraphs (1) and (2) of subsection (a) shall not apply to any farming business.

From this section, one can arrive at two conclusions: 1) that S Corporations, most partnerships and sole proprietorships in the nursery industry may use cash basis accounting and 2) the prohibition on cash basis accounting do not apply to C corporations and certain partnerships engaged in farming.

IRC Section 447 addresses the status of farming C corporations and it explicitly excepts nursery and sod farms, regardless of size, from the requirement to use accrual basis of accounting.

26 USC § 447 - Method of accounting for corporations engaged in farming

(a) General rule

Except as otherwise provided by law, the taxable income from farming of—

(1) a corporation engaged in the trade or business of farming, or

(2) a partnership engaged in the trade or business of farming, if a corporation is a partner in such partnership, shall be computed on an accrual method of accounting.

This section shall not apply to the trade or business of operating a nursery or sod farm or to the raising or harvesting of trees (other than fruit and nut trees).

It should be noted that sometimes there is confusion about the application of IRC Section 447 as there is a gross receipts exception further down in the section. For nursery taxpayers, the statement in the general rule is the **entire** section itself does not apply to nursery and sod farmers, so there is no reason for gross receipts exception to be at issue.

The next issue is whether the cost of plant material must be capitalized. The analysis for that begins with IRC Section 263A. There are actually three elements of IRC Section

263A that provide separate and sometimes redundant exceptions from the requirements of IRC Section 263A for the industry.

The first potential exception is based on size found in IRC Section 263A (b)(2)(B)

26 USC § 263A - Capitalization and inclusion in inventory costs of certain expenses

(a) Nondeductibility of certain direct and indirect costs

(1) In general

In the case of any property to which this section applies, any costs described in paragraph (2)—

(A) in the case of property which is inventory in the hands of the taxpayer, shall be included in inventory costs, and

(B) in the case of any other property, shall be capitalized.

(2) Allocable costs

The costs described in this paragraph with respect to any property are—

(A) the direct costs of such property, and

(B) such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property.

Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.

(b) Property to which section applies

Except as otherwise provided in this section, this section shall apply to—

(1) Property produced by taxpayer

Real or tangible personal property produced by the taxpayer.

(2) Property acquired for resale

(A) In general

Real or personal property described in section 1221 (a)(1) which is acquired by the taxpayer for resale.

(B) Exception for taxpayer with gross receipts of \$10,000,000 or less

Subparagraph (A) shall not apply to any personal property acquired during any taxable year by the taxpayer for resale if the average annual gross receipts of the taxpayer (or any predecessor) for the 3-taxable year period ending with the taxable year preceding such taxable year do not exceed \$10,000,000.

The second potential exception is based the short preproductive period of some plant material found in IRC Section 263A (d)(1)(A)(ii)

(d) Exception for farming businesses

(1) Section not to apply to certain property

(A) In general

This section shall not apply to any of the following which is produced by the taxpayer in a farming business:

(i) Any animal.

(ii) Any plant which has a preproductive period of 2 years or less.

(B) Exception for taxpayers required to use accrual method

Subparagraph (A) shall not apply to any corporation, partnership, or tax shelter required to use an accrual method of accounting under section 447 or 448 (a)(3).

It should be noted, as it states in IRC Section 263A (d)(1)(B) above, that this exception hinges on the aforementioned exceptions from the required use of accrual accounting in IRC Sections 447 and 448.

There is one “elective” exception from IRC Section 263A that does not rest on size of business of the preproductive period of the plant material that **is commonly used** by nursery taxpayers. It is found in IRC Section 263A (d)(3)(A)

(3) Election to have this section not apply

(A) In general

*If a taxpayer makes an election under this paragraph, this section **shall not apply to any plant produced in any farming business** carried on by such taxpayer.*

The election is to “forego” accelerated depreciation for other farm assets. It is found in IRC Code Section 263A(e)(2)(A)

(2) Effects of election on depreciation

(A) In general

If the taxpayer (or any related person) makes an election under subsection (d)(3), the provisions of section 168 (g)(2) (relating to alternative depreciation) shall apply to all property of the taxpayer used predominantly in the farming business and placed in service in any taxable year during which any such election is in effect.

It should be noted that there are two additional provisions of IRC Section 263A that related to this “elective” exception. Once again, the exceptions from IRS Sections 447 and 448 are relevant. IRC Section 263A (d)(3)(B) states:

(B) Certain persons not eligible

No election may be made under this paragraph by a corporation, partnership, or tax shelter, if such corporation, partnership, or tax shelter is required to use an accrual method of accounting under section 447 or 448 (a)(3).

There is a definition of farming that makes it clear that nursery taxpayers are included in the businesses eligible for the “elective” exception. IRC Section 263A (e)(4) states:

(4) Farming business

For purposes of this section—

(A) In general

The term “farming business” means the trade or business of farming.

(B) Certain trades and businesses included

The term “farming business” shall include the trade or business of—

(i) operating a nursery or sod farm, or

The analysis now takes us to whether there is a requirement to maintain an inventory, regardless of whether a nursery is on cash basis or accrual basis accounting.

For cash basis accounting, the principal authorities are found in IRS regulations.

IRC Section 162 is the general section outlining ordinary trade and business expenses. The regulations thereunder (26 Code of Federal Regulations (CFR) 1.162.-12) provides the basis for the current deductibility of farming expenses.

26 CFR 1.162-12 - Expenses of farmers.

Expenses of farmers.

*(a) Farms engaged in for profit. A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. For rules regarding the capitalization of expenses of producing property in the trade or business of farming, see section 263A and the regulations thereunder. For taxable years beginning after July 12, 1972, where a farmer is engaged in producing crops and the process of gathering and disposal of such crops is not completed within the taxable year in which such crops were planted, expenses deducted may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be determined upon the crop method, and such deductions must be taken in the taxable year in which the gross income from the crop has been realized. For taxable years beginning on or before July 12, 1972, where a farmer is engaged in producing crops which take more than a year from the time of planting to the process of gathering and disposal, expenses deducted may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be determined upon the crop method, and such deductions must be taken in the taxable year in which the gross income from the crop has been realized. **If a farmer does not compute income upon the crop method, the cost of seeds and young plants which are purchased for further development and cultivation prior to sale in later years may be deducted as an expense for the year of purchase, provided the farmer follows a consistent practice of deducting such costs as an expense from year to year.***

Over the years, there has been much “discussion” between the Internal Revenue Service (IRS) and the industry over the words “further development and cultivation” in the bold

sentence, but the regulation has held as the general principle of the current deductibility of plant material since its promulgation in the mid 1950's.

In addition, IRC Section 471 gives the IRS the authority to require inventories in certain circumstances. The regulation thereunder indicates the choice is up to the farmer to choose inventories or cash basis accounting:

26 CFR 1.471-6 Inventories of livestock raisers and other farmers.

*(a) **A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used** but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner*

From time to time, there has been a question as to whether a nursery taxpayer using accrual accounting would be required to use inventory accounting. In 1978, Congress addressed the issue, and to our knowledge, this remains valid law.

Section 352 of Revenue Act of 1978, Pub. L. No. 95-600, 95th Cong., 2d Sess., (November 6, 1978) provides as follows:

(a) APPLICATION OF SECTION.-This section shall apply to a taxpayer who-

(1) is a farmer, nurseryman, or florist,

(2) is on an accrual method of accounting, and

(3) is not required by section 447 of the Internal Revenue Code of 1954 to capitalize preproductive period expenses.

(b) TAXPAYER MAY NOT BE REQUIRED TO INVENTORY GROWING CROPS.-A taxpayer to whom this section applies may not be required to inventory growing crops for any taxable year beginning after December 31, 1977.

(c) TAXPAYER MAY ELECT TO CHANGE TO CASH METHOD.-A taxpayer to whom this section applies may, for any taxable year beginning after December 31, 1977 and before January 1, 1981, change to the cash receipts and disbursements method of accounting with respect to any trade or business in which the principal activity is growing crops.

For the record, the original administrative rulings promulgated 90 years ago, upon which this consistent and continuing practice was built, were as follows:

I.T. 1368, I-1 C.B. 72 (1922) held that (1) farmers would not be permitted to inventory growing crops in determining gross income, and (2) nurserymen may inventory their

young trees only when they had reached a marketable size and stage of development and when the market value is definitely known.

O.D. 995, 5 C.B. 63 (1921) held that florists are not required to inventory growing plants for the purpose of calculating their net income for income tax purposes.